IHS Global Insight Article

Report printed on 21 June 2010

CONTENTS

State and Local Government Budgets: Tough Decisions Ahead

Federal stimulus money from the ARRA is set to expire at the end of 2010. With no clear indication that there will be any extension to federal aid in 2011, states and local municipalities will need to make hard decisions to balance their budgets. A potentially even more severe problem lurking in the background is that of unfunded pension liabilities.

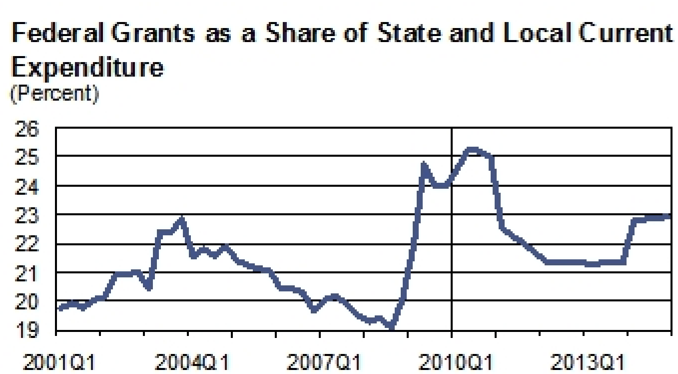
Overview

The financial crisis has left deep scars on state and local government budgets. Moreover, although the outlook is brightening for the economy as a whole, the fiscal situation of state and local governments is still darkening.

This was not unexpected, however. States and localities usually face the worst of the storm within a year or two after the trough of the recession. There are two reasons for that.

On the spending side, recessions generally result in a larger share of the population calling upon existing social safety nets, thus directly increasing state spending. In this case, to make up for some of the additional spending burden, the American Recovery and Reinvestment Act (ARRA) provided federal assistance to states, including $87 billion in Medicaid grants and approximately $50 billion to the State Fiscal Stabilization Fund to be spent primarily on education. However, the ARRA is not meant to last forever, and the Medicaid and education assistance programs are set to expire at the end of 2010. Barring any extension of these federal aid programs, states and local municipalities will be faced with a significant drop in revenues, and tough decisions regarding spending. In addition, they face unfunded pension liabilities, rising healthcare costs, tapped or depleted rainy-day funds, and the challenge of making up for deferred investments in 2011 without the help of the federal government.

Federal support for current state and local expenditures has risen considerably from a low point of 19% in mid-2008 to a peak of 25% in the second quarter of 2010. This share drops considerably in 2011, when the federal ARRA support ends, and it starts rising again by 2014 as the federal government picks up a large part of the extension of Medicaid insurance related to the healthcare reform.



On the revenue side, the timing of tax collections is the main factor explaining a lag between recessions and their impact on state and local economies. For fiscal year 2010 (FY2010), which is coming to a close on June 30 for most states, final income tax settlements collected in April 2010 were based on revenues earned in 2009, when the recession was at its most severe. Therefore, poor economic performance in one year translates into lower tax revenues in the subsequent year(s).

The bottom line is that the stimulus money from the ARRA has allowed state and local governments to postpone the toughest decisions, either to make drastic cuts to spending, and/or to take bold fiscal measures to boost revenues. However, as states and local municipalities face large and potentially growing budget gaps, these decisions will likely be forced upon them in order to balance their budgets. Indeed, all states except Vermont have a legal requirement to balance their budgets on an annual or biennial basis. With the end of FY2010 rapidly approaching, spending cuts and tax increases will become the new norm.

It is not clear at present whether there will be any extension to federal aid in 2011, but the mood in Congress is hostile to further stimulus. According to a report by the National Conference of State Legislatures, 30 states have incorporated an assumed six-month extension of Medicaid grants through June 2011, so they will have to take remedial action if those funds do not appear.

Budget Gaps

Spending: Cuts, Cuts, Cuts

The National Association of State Budget Officers (NASBO) wrote in its June 2010 Fiscal Survey of States that 40 states cut their midyear budgets for FY2010 by a total of $22 billion, in addition to the $55.7 reduction in expenditure by 36 states prior to enacting their FY2010 budgets. In FY2009, 43 states had already made midyear budget cuts worth $31.3 billion. By contrast, the 2001 recession resulted in states cutting their expenditures by just $14 billion in 2002 and $12 billion in 2003.

For fiscal 2010, 36 states enacted targeted cuts and 28 states made across-the-board cuts; 26 states laid off personnel; and 19 dipped into their rainy-day funds. Among the largest reductions prior to the FY2010 budget enactment, California stands out for the $20.4 billion reduction in its expenditures (which follows cuts of $10.7 billion during FY2009). Other major expenditure reductions include New York ($6.0 billion), New Jersey ($3.3 billion), Georgia ($2.6 billion) and Massachusetts ($2.4 billion).

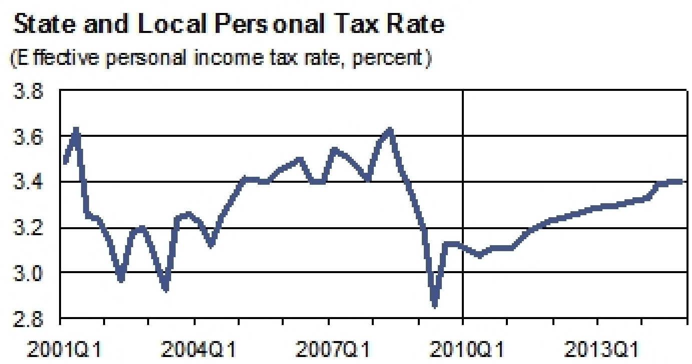
Despite having solved budget gaps worth $73.1 billion in 2009 and $92.6 billion in the first 11 months of FY2010, NASBO reported that states still faced budget gaps worth $11.6 billion for FY2010. For FY2011 and FY2012, states reported budget gaps totaling $115.7 billion, but this number may still rise as not all states have reported exact gap estimates.

Indeed, states will have to continue making spending adjustments in the coming quarters. Among the proposed cuts, education and health programs are likely to be most affected. The American Association of School Administrators said in a recent study that approximately 275,000 education jobs could be eliminated in the 2010/11 school year due to budget cuts. The city of New York alone could lose up to one-tenth of its teachers (or 6,400 jobs). Beyond education and health, the broader public employee sector that covers everything from state parks to the state police is also likely to be a target. New York's Governor Paterson sought to rein in expenses by imposing a one day per week furlough for 100,000 public sector workers as part of an emergency spending bill. California's Governor Schwarzenegger is following suit. His FY2011 budget shows a budget gap of $19.1 billion, which will be eliminated through deep cuts to welfare and health programs as well as cuts in the education and public service sector.

Revenue: Higher than Last Year Thanks to Tax Increases, But Short of Expectations

To rebuild their financial position, state governments are enacting tax increases worth $23.9 billion in FY2010 and $3.1 billion in FY2011, according to NASBO. For FY2010, these include increases in personal income taxes (worth $10.7 billion), sales taxes (worth $6.1 billion), and fees (worth $5.1 billion), combined with a minor decrease in corporate income taxes (down $0.2 billion). New York and California will account for almost 70% of these tax increases. California increased its marginal tax rate on personal income by 0.25% and bumped the sales tax rate by 1.0%. New York temporarily increased the income tax rate for incomes above $500,000 to 8.97%, and enacted an increase in various fees in hope of collecting $1.9 billion. For FY2011, NASBO expects state personal income, corporate, and sales taxes revenues will drop a total of $1.9 billion, but these will be compensated for by tobacco, motor fuels, and other taxes and fees worth $5.0 billion.

According to the Rockefeller Institute State Revenue Report of April 2010, revenues are still falling, albeit more slowly. The last calendar quarter of 2009 was the fifth consecutive quarter of declining year-over-year (y/y) revenues—the longest streak since 1962. Total tax revenues in the fourth quarter of 2009 were 4.2% lower than the preceding year, and 8.6% lower than in the last quarter of 2007. All three major components of revenue showed declines relative to the same quarter in the preceding year: income tax revenues were down 4.6%, corporate tax revenues fell 5.3%, and sales taxes dropped 3.6%. Local governments, as a whole, have fared relatively better than state governments as they rely heavily on property tax revenues, which tend to be relatively stable. During the last quarter of 2009, overall local taxes rose 4.6% y/y thanks to the strong 5.6% y/y growth of property tax revenues. The overall rosy picture, however, hides the dire situation of some localities around the United States, which are faced with much lower housing prices.



From a "glass half-empty" perspective, the picture of lower tax revenues is not very encouraging. However, the "glass half-full" perspective illustrates that states can reverse or slow the trend through tax hikes (although these can be taken only so far, since they risk driving economic activity away to lower-tax locations). For example, California's tax revenues increased 1.3% while New York's revenues increased 4.4% in the last quarter of 2009 relative to the preceding year. But for many states, April tax collections came in short of expectations. April is generally considered the largest revenue month for states, as they collect taxes from the preceding year. Unfortunately, preliminary data from states have shown lower than expected income tax revenues, thus creating a new round of budget gaps. The National Conference of State Legislatures reported in April that the combined budget gap for 38 states and Puerto Rico would reach $89 billion in FY2011.

The Pensions Time Bomb

Current deficits are not the only worry for state and local budgets. A potentially even more severe problem lurking in the background is that of unfunded pension liabilities.

A recent study by Joshua Rauh, economist at Northwestern University, concludes that state pension funds will run dry between 2018 and 2020 for seven states (Illinois, Connecticut, Indiana, New Jersey, Hawaii, Louisiana, and Oklahoma), and that a total of 31 states will run dry by 2030 ("Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities," 2010, Kellogg School of Management, Northwestern University). The situation gets even more dire by 2050, as all but five states (Alaska, Florida, Nevada, New York and North Carolina) would face dried-up state pension funds. Rauh's conclusion holds under the assumption that states use future contributions to fund new benefits in full (thus, no extra funding is obtained to cover existing liabilities), and that the pension funds generate an average return of 8%.

While the underlying assumptions and the timing of the conclusions of this study can be debated, unfunded state pension liabilities are clearly a ticking time bomb. While the legal requirements that oblige states to balance their budgets on an annual or biennial basis are a safeguard (but not a guarantee) against default, off-balance-sheet debt in the form of unfunded pension liabilities could still cause state insolvency. The tax hikes or spending cuts (including cuts in pension benefits for existing or new workers) needed to cover them could become so large as to be politically infeasible. The question would then be whether the federal government would bail out insolvent states, which is far from assured given the condition of federal finances.

by Gregory Daco

